StraightTalk

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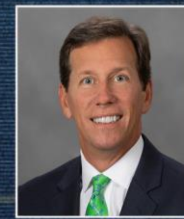

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Oil, Inflation, and Stocks…All Higher?

The first quarter ended with the stock market rallying off of the lows of February – even as the news from Ukraine became more dire. Other headlines about oil prices and the pace of inflation also worsened, so why are stocks moving higher? The answer has several components; one of them could well be that portfolio managers and investors sense an opportunity in the first real pullback since the onset of Covid two years ago.

To offer guidance on where we might be today, the global research firm, Applied Global Macro, looked at all situations during the last thirty years in which the market declined 10% without the economy being in a recession. Their research found that investing on the day the S&P 500 dropped 10% from its high resulted in gains over the following 100 days in all 14 of those 14 instances. Now, *none of us* should be investing with a timeline of only three months, but having an idea of what has followed these routine non-recessionary price dips should be helpful to our collective psyche.

Of course, the question on everyone's mind is, are we actually heading towards a recession due to Russia's war on Ukraine, or high oil prices, or inflation. My answer to that tri-part question is no, no, and it depends. While Russia's brutal war crimes are horrific for the people of Ukraine, the disruption to oil (from Russia) and grain (from Ukraine) is not enough to tilt our economy into a recession. Our country is extremely fortunate in our geography, in that we have enormous petroleum reserves under our soil, and some of the most fertile and productive farmland on top of it. Remember that away from those two global commodities, the companies of America, as represented by the S&P 500, have less than one percent direct exposure to those two countries – their economies just do not consume or produce that much.

Speaking of oil – releasing reserves from our stockpile is a short term band aid often deployed by our Presidents; Clinton, both Bushes, Obama, and Biden have all done so in times of price shock, but what ultimately cures high price is…high price. When the pain at the pump causes people to rethink their miles driven, demand falls, and prices float down. However, coming out of the onerous restrictions during the pandemic, most of us will just endure the pain of gas prices to do what we were not able to do during the two previous summers. In fact, in a March survey, AAA found that while nearly two-thirds of Americans felt prices were too high at the pump, 80% plan to travel this summer anyway.

Moreover, there is some hope that supply might increase by this fall. Oil analysts often state that almost all wells in this country are profitable to operate when oil prices are above $80 per barrel. This likely means (despite sensational news headlines to the contrary), more supply on the market later this year, not less. Speaking of sensational headlines, Amos Hochstein, the Senior Advisor for U.S. Energy Security, discussed misleading news recently in his March interview on Bloomberg Television. In that interview, he explained that he was in Riyadh in February waiting to meet with the Saudis to discuss oil supply, when breaking news headlines of what was said by both sides appeared on his tablet – an hour before the meeting even occurred! *News media misleading…who would have guessed?*

He also pointed out that after a severe demand shock like the one we saw in the Covid shutdown, it takes some time to ramp supply up again in an ordinary environment. Today, of course, the oil patch is also suffering from the same supply chain issues facing most other industries – specifically steel, concrete, and labor shortages. The U.S. Energy Department's estimates are that between 900,000 and one million additional oil barrels per day will be on the market by the third quarter, which combined with the one million per day being released from the SPR will normalize supply, resulting in lower prices. Stay tuned for that this fall…

My "it depends" answer to the recession question relates to inflation, or more specifically the Federal Reserve's policy response to that inflation. In the only bout of systemic inflation any of us have lived through – the late 1970s – the rate of inflation zoomed upward, pushing prices in the economy higher, while business spending and productivity declined. In the face of these trends, Paul Volcker raised interest rates from 11.2% to 20%, forcing the economy into a painful recession to break the upward inflationary spiral. Unemployment rates did increase two percentage points, but inflation dropped much more, from 13.5% to 3.5% in just two years. In short, although painful, the Fed-induced recession was worth it to curb inflation.

However, that is a long, long way from where we are today. Yes, inflation is running at 7.5% – and may hit 8% this month before beginning to slow later this year. Notably, many of the inputs to inflation (away from oil and wages) are a direct result of the horrific decision in 2020 to close our economy and wreck the national supply chain. Raising short-term interest rates will not help container ships be unloaded, or make furniture or microchips be manufactured faster, only time will solve those supply chain issues. And the most telling difference between today's inflation and that of the 1970s, is where we are in the business cycle. Rather than a slowdown in business spending, referred to as capital expenditures (or capex) – businesses today are increasing their spending. The Wall Street Journal expects capex this year to grow 6.1% over last year's rate, as corporate America's cash levels have increased another 11% to almost $4 trillion.

Not only are today's corporate balance sheets much stronger than they were in the 1970s, productivity per hour is at all-time highs. Federated Investors notes that productivity surged at a 6.6% annual rate for the fourth quarter of last year, the second fastest pace in more than a decade. With the current global trade bottlenecks and wage pressures, I expect corporate America to continue to on-shore supply chains, and automate where they can. Artificial Intelligence and robotics are becoming a mainstay of business today, which yields a different picture than the 1.5% productivity numbers of fifty years ago. Remember that technology is deflationary, meaning that it drives costs down over time. The smart phone in your hand has more computing power than all of NASA's Apollo computers in the 1960s. And, although it has estimated processing speeds one million times faster, that phone costs $1.5 million less than the Apollo guidance computer.

However, it is not just the continuously falling cost of technology, it is also the increasing output (or productivity) that comes from using that technology. As an example, drones or robots occasionally need service, but do not require health care, a 401(k), or take sick days. If the increased use of technology and untangling of the supply chain does not help to bring inflation down over the course of the next year, the Fed may yet have to use the Volcker playbook, but it is too early to know that. What we do know is that raising interest rates from zero to 3% is much less drastic than pushing those rates to 20%. So, I will be keeping a close eye on the Fed, but will also be watching stock buybacks and the number of companies announcing dividend increases as a leading barometer of business health.

At the end of the day, any investor in the great companies of America and the world is not really buying for today's profit margin, business model, or current dividend. He or she should be investing for what those profits and dividend streams can be in the future. One possible answer to why the market has moved higher in the face of bad news is that those future numbers look more attractive, not less so. Ask any bond trader how the "safety" of bonds turned out last quarter and you will likely be met with a grimace. While stocks were down about 5% for the quarter, bonds lost almost twice that amount, wiping more than $2.6 trillion from the Global Aggregate Index. That is the biggest bond decline in forty years, as bond traders are anticipating higher interest rates. Owning debt in a rising interest rate environment is something none of us have really seen since the Volcker and Reagan era. Since 1982, we have had decades of falling interest rates, from a high of 20% to zero. Interest rates are now clearly heading higher, which means a difficult environment for bonds.

Indeed, owning shares of the great companies continues to be the very best protection over time from the ravages of inflation and taxes...

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